

APPRAISAL 3100
APPRAISAL STUDY FOR IMPLEMENTING 50% RENT
INCREASE UNDER CH 138 SLA 1977 AND CH 182 SLA 1978

by
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BACKGROUND

Between 1974 and 1978 land values in most of Alaska increased dramatically. The annual rent paid for land leased from the State of Alaska increased similarly when five-year rent adjustments came due. To reduce this burden on lessees of state land, the legislature amended AS 38.05.085.¹ The amended statute allowed for a fixed rental amount for 25 years. The statute also requires DNR to fix a new rent amount at the end of 25 years and every 10 years thereafter, until the lease expires.² AS 38.05.085 requires the adjusted rent to be based on one or more appraisals, but sets an upper limit on any rent increase.³ Whichever of the following results in the lowest rent increase must be used:

- current market rent,
- 10% of the new market value, or
- 150% of the rent paid during the previous time period.

The 25-year level rent provision was repealed effective July 1, 1992 by § 37 ch 2 FSSLA 1992. Leases since that time now require reappraisal every 5 years.

PURPOSE AND INTENDED USE OF THIS STUDY

An informal count by the appraisal unit indicates that approximately 175 leases come due for rent adjustments between 2002 and 2004 after 25 years of level rent. (See attached.) Because most leases were converted in 1978, most come due in 2003. Formal appraisals would overtax the small DNR appraisal staff and would also involve a significant expense for DNR and its lessees. That is the purpose for this study.

In most of the lease areas scheduled for adjustment, real estate values have increased dramatically during the past 25 years, far beyond amounts allowed by statutory limitations for rent adjustments. If such increases can be reliably demonstrated by a method that is less costly and time-consuming than a formal appraisal, DNR and its lessees could avoid needless appraisals while still meeting the requirements of AS 38.05.085.

¹ Ch 138 SLA 1977 and ch 182 SLA 1978 affected new and existing leases. Existing leases could be converted from a five-year rent adjustment period to a 25-year period.

² Maximum lease term is 55 years, after which leases may be renewed for a like time period under whatever terms and conditions are legally required at the time of renewal.

³ Ch 138 SLA 1977 requires the lessee and DNR to each appoint an MAI appraiser. If the 2 appraisals agree, they are binding on the parties. If they do not agree, a third appraisal is then obtained, and the two closest appraisals are averaged. Ch 182 SLA 1978 requires only 1 appraisal to start with, but up to three appraisals may be necessary. Under both legislative schemes, DNR and the lessee pay an equal share of the appraisal expenses.

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SUMMARY OF FINDINGS AND RECOMMENDED ACTION

We studied lease information and comparable sales for lands similar to those requiring rent adjustments. Based on available data, we make general conclusions and recommendations. However, this study is not intended to cover every actual case.

10% Rental Rate Ceiling

Current market rental rates are expected to be less than 10%. The 10% rental rate ceiling has little potential as a rent ceiling.

Converted Leases

During the past 25 years, land values and rental rates have increased throughout the state. These increases indicate that the 150% rent ceiling is likely to apply in all cases. We believe it is pointless to appraise converted leases. There may be a few cases where current appraised market rent is less than the other two allowable statutory minimums, but the probability is very low; it is most likely to occur in the Copper River Basin.

Leases Originally Issued With 25 Years of Level Rent (New Leases)

Initial rental rates for these leases were higher than initial rates for converted leases due to market conditions as of the date of issuance⁴ and due to the market tendency to compensate for the long, 25-year, fixed term.⁵ The new adjusted rent will be fixed for 10 years rather than 25. Therefore, increases in land values will be somewhat offset by decreases in rental rates. If the increase in land value fails to offset the decrease in the rental rate, current market rent will be less than the other two statutory minimums.

In the Northern and Southeast Regions, increases in land values are more than sufficient to offset any decreases in rental rates. The 150% rent ceiling should apply in all cases. In Southcentral Region, increases in land value have been less dramatic. Nonetheless, the 150% rent ceiling should apply for most leases in Southcentral. The Copper River Basin is a possible exception.

Lessee Notification

DNR should notify all lessees at least one year before the rent anniversary date that a rent adjustment is scheduled. All lessees should be given the option of accepting a plus 50% rent increase in lieu of appraisal. (See attached draft letter.) For low-rent leases, appraisal costs could exceed rent savings.

⁴ Most were issued in the early 1980s when the prime rate was high. See attached chart and graph titled *Summary of Rental Rate Study 1980 through 1992*.

⁵ Rates for 25-year fixed rent terms were generally 2% to 4% higher than rates for 5-year terms.

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REAL ESTATE TRENDS

Since 1974, real estate values in many areas of the state have been through several cycles. First were dramatic increases during construction of the Trans-Alaska Pipeline (1975-78), then a softening market in 1979 with a very high Prime Rate. Values began a long rise between 1980 and 1984-85. After the crash in the price of crude oil about 1985, coupled with changes in the federal income tax code in 1986,⁶ real estate values in many areas of Alaska went into a free-fall and stabilized about 1990. From that point the rise has been fairly steady in most areas of the state, with a few static areas. The inception or conversion of the leases in question took place during the pipeline boom. Our analysis seeks to bridge these periods between the soft market of 1979, the subsequent rise of the early 1980s, and the crash of the late 1980s into the current period where the various markets are now static or steadily growing.

METHODOLOGY

We began by examining appraisals for leases with five-year adjustment periods that were initiated or appraised in the mid to late 1970s. We chose parcels having locations, sizes, and highest and best uses that were similar to the properties scheduled for rent adjustments. We looked at appraised land values, appraised rent amounts, and appraised rental rates.⁷ In order to span the up and down cycle of the 1980s, appraised values from the 1970s were compared to more recent appraised values for the same parcels.

In addition to reappraisals, we also researched other comparable data from DNR records, private records, and assessors' records. This research did not provide the conclusive evidence we needed and is not reported.

ANALYSIS

There are a very limited number of reliable rent and land value comparisons for the time period in question.⁸ Therefore, this study includes a sensitivity analysis to help show how changes in land value and lease rates affect potential rent amounts.

10% Rental Rate Ceiling

Rent amounts for long-term leases initiated with 25-year rent adjustments (new leases) were typically 10% to 12% of the market value of the land; some lease rates in Southeast were as high as 15% in the early 1980s.

Rental rates for long-term leases with 5-year rent adjustments have typically been lower. During the 1970s, they were typically based on 6% to 7% of the market value of the land. More recently, they have been based on 8% of land value, with some residential rates at 6%.

⁶ The revised tax code eliminated accelerated depreciation and deduction of interest payments on raw land.

⁷ Rental rate is defined as the "...rate, expressed as a percentage of fair market value, which a comparable class of privately-owned property would bring in the open market with the same conditions of lease as offered by the state." (AS 38.05.085(g)(2), repealed § 37 ch 2 FSSLA 1992)

⁸ Because most leases converted in 1977 and 1978 based on earlier appraisals, it is difficult to find appraisals of leases with five-year adjustments after 1974. For those leases that did not convert, few five-year rent adjustment appraisals were done until the early 1990s due to other workload priorities.

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The current environment for interest rates is approaching historically low levels. We predict that appraised market rental rates for the upcoming 10-year adjustment period will range between 6% to 9%. This range is lower than historical rates for the longer, 25-year, level-rent period and slightly higher than current market rates for a shorter, 5-year adjustment period. This predicted range eliminates consideration of the statutory rental rate ceiling of 10%, leaving market rent or the 150% rent amount as possible ceilings.

Northern Region

In the Northern Region, only parcels in the North Slope Industrial Subdivision are due for rent adjustments. We examined leases in that subdivision that were initiated in 1978 and compared the initial rents with rent reappraisals that were done during the late 1980s and mid-1990s for the same parcels. The rent amounts increased by an average of 37% per year between 1978 and 1992. Other 5-year reappraisals for pipeline rights-of-way indicate that demand for lots in the North Slope Industrial Subdivision has declined, and values have been relatively stable in recent years.

Based on this information, we assume that land values in the subject subdivision increased at an annual rate exceeding 6% per year during the past 25 years. We also assume that a current market rental rate for the industrial use will range between 8% to 9%. Using these assumptions, the attached *Sensitivity Analysis* supports the 150% rent ceiling (a rent increase of 1.6% per year) for all parcels in question.

Southeast Region

Properties in the Southeast Region vary in highest and best use and location. Southeast locations include Hyder, Ketchikan, Prince of Wales Island, Petersburg, Chicagof Island, Haines, Hoonah, and Elfin Cove. We were able to analyze sales and leases in the majority of sub-areas and found that rent amounts have increased by an average annual rate of 10.4% between 1974 and 1998.

Based on this information, we assume that land values throughout Southeast increased at annual rates that equal or exceed 6% per year during the past 25 years. We also assume that current market rental rates for the various uses will range between 6% and 9%. Using these assumptions, the attached *Sensitivity Analysis* supports the 150% rent ceiling for all the leases in Southeast.

Southcentral Region

The Southcentral Region requires a more complex analysis. Properties vary substantially in highest and best use and location, and changes in land value vary widely among the various markets. Locations include Naknek, Seward, North Kenai to Kasilof, Cordova, West Cook Inlet, Pt. MacKenzie, Wasilla, Talkeetna, and Copper Center. Property uses include recreational/residential sites, commercial sites, and industrial tidelands.

Of the three regions, Southcentral experienced the lowest rates of increase in land values and rent amounts during the past 25 years. Data in the attached *Rent Comparisons* chart show that land values in Southcentral averaged an annual rate of increase of approximately 6% between 1974 and 1998. The lowest annual increase of 2.5% was for a parcel near Wasilla between 1983 and 1994; those years mostly reflect the mid 1980s market crash. One other parcel in Talkeetna indicates an annual rate of just less than 3% between 1975 and 1998. Sales and non-lease appraisals in the Glenallen/Copper

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Center area (not included in this report) indicate that the rate of increase in land values may have been less than 1% per year since the mid-1970s.

Rent amounts throughout Southcentral increased at an average annual rate of 7.7%, with a low of 2.9% for a Public and Charitable lease in Talkeetna. Appraisals for the Glennallen/Copper Center segment of the Trans-Alaska pipeline indicate an increase in rent amounts of 60% between 1980 and 1991.

The above data indicates that the 150% rent ceiling will apply for most leases in Southcentral. However, exceptions are possible.

Because rental rates for new leases will drop, and rental rates for converted leases will be stable or slightly higher, the 150% rent ceiling is a greater mathematical possibility for converted leases. Prior to conversion, rents for converted leases were 6% to 7% of market value. At the time of conversion, annual rent amounts were adjusted upward by 10% per year from the last date of appraisal. Land values probably increased by more than 10% per year during that time period. Therefore, the actual rental rate basis for converted leases was less than 6% to 7% at the time of conversion. The *Sensitivity Analysis* shows that increases in land value as low as 1% per year are sufficient to bring the 150% rent amount ceiling into operation. Therefore, the 150% rent ceiling applies to all converted leases in Southcentral, just as it does with the other regions. The Copper River Basin area is a possible exception. Data in the Copper River Basin is mixed.

For new leases that were initiated with a higher effective rental rate than current market rates, Southcentral's average overall land value increase of 6% per year clearly brings the 150% rent amount ceiling into operation. When the increase in land value drops below approximately 2% per year, market rent is lower than the 150% rent amount ceiling.

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APPRAISAL COSTS

For low-rent leases, appraisal costs could exceed rent savings. Appraisal costs depend on the appraiser's expenses, his or her experience and level of qualifications, how difficult the assignment is, and the time-frame to complete the appraisal. Because an appraiser is required to physically inspect the appraised properties and similar properties that have recently leased or sold, appraisals for remote and rural sites are often expensive, even though the rent is low. Table E shows the relationship between appraisal costs, rent savings, and increases in land value. We have capitalized values at 5% to approximate what a lessee could obtain by depositing the money in the bank as a safe investment.

TABLE E	Low	Typical	High
Total Appraisal Cost Per Parcel	\$500	\$2,500	\$6,000
Lessee's Share @50%	\$250	\$1,250	\$3,000
FV of Lessee's Share at 5%, 10 yrs	\$407	\$2,036	\$4,887
Required Rent Savings (Annual Recapture of FV at 5%, 10 yrs)	\$32	\$162	\$389
Maximum Total Indicated Land Value Increase w/ Annual Recapture Capitalized @ 6% Rental Rate	\$540	\$2,698	\$6,475
Minimum Total Indicated Land Value Increase w/ Annual Recapture Capitalized @ 9% Rental Rate	\$360	\$1,799	\$4,317

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Attachment: Sensitivity Analysis 1%, 2%, 3%, and 6%
Summary of Rental Rate Study 1980 through 1992
DNR Appraised Rental Rates 1980 through 1992
Rent Comparisons from DNR Appraisals 1974 through 2000
Leases scheduled for 25 year rent adjustment
Draft Lessee Notification Letter
Lease Location Maps